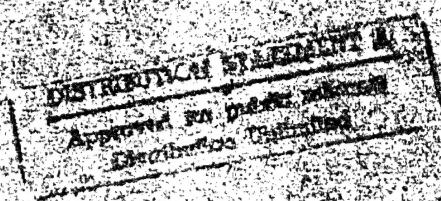


**DTIC Documentation  
of Credit and Savings  
NSB Decision Was  
Inadequate**



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## General Government Division

B-248901

July 7, 1992

The Honorable Donald W. Riegle, Jr.  
Chairman, Committee on Banking,  
Housing, and Urban Affairs  
United States Senate

The Honorable Henry B. Gonzalez  
Chairman, Committee on Banking,  
Finance and Urban Affairs  
House of Representatives

*FAILED BANK: FDIC  
DOCUMENTATION OF  
CROSSLAND SAVINGS, FSB,  
DECISION WAS  
INADEQUATE*

This report responds to your respective February 10, 1992, and February 6, 1992, letters asking us to examine the Federal Deposit Insurance Corporation's (FDIC) resolution actions regarding the failed CrossLand Savings, FSB, of Brooklyn, NY. We are responding to both requests with this report because your separate requests concerned the same topic.

On January 24, 1992, the Office of Thrift Supervision (OTS) closed CrossLand and named FDIC receiver for the failed bank. The FDIC Board of Directors decided to delay the final resolution of CrossLand—because it found the bids it had received to be more costly than interim FDIC control—by arranging to operate it under a conservatorship for an interim period and then offer it again to the private sector. You asked if this decision met the requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),<sup>1</sup> which generally requires FDIC to resolve a failed bank in the manner that results in the least cost to the deposit insurance fund.

## Background

When a bank fails, FDIC typically fulfills its deposit insurance obligations by taking one of the following approaches:

- selling the failed bank's deposits, certain other liabilities, and some or all of its assets to an acquirer (purchase and assumption);
- selling only the bank's insured deposits and certain other liabilities—but none of its assets—to an acquirer (insured deposit transfer); or
- directly paying depositors the insured amount of their deposits and disposing of the failed bank's assets (deposit payoff).

<sup>1</sup>Public Law 102-242 (105 Stat 2236, sec. 141). This section of FDICIA amended section 13(c) of the Federal Deposit Insurance Act (12 U.S.C.A. 1823(c)(Supp. 1992)).

Under the first two approaches, the acquirer usually pays a premium for the portion of the failed bank it acquires. The cost to FDIC of the bank failure is thus equal to the amount of deposits and other liabilities assumed by the acquirer, minus any premium received by FDIC for the deposits, and minus FDIC's share of the net proceeds from disposal of the failed bank's assets. In a deposit payoff, FDIC pays off the bank's insured deposits and then disposes of the bank's assets. In this case, FDIC's cost is the amount of insured deposits paid out minus its net recoveries on asset disposition.<sup>2</sup>

Before FDICIA, FDIC was required to resolve failed banks in a manner that was no more costly than a deposit payoff. FDICIA requires, in the absence of a determination of systemic risk, that FDIC resolve failed depository institutions in the manner that is the least costly "of all possible methods for meeting the Corporation's obligation under this section."<sup>3</sup> FDICIA also contains several requirements concerning the documentation of FDIC's resolution decisions.

FDIC began the process of resolving CrossLand in April 1991. After marketing CrossLand from August to December, FDIC received two bids for the institution's deposits in December 1991. The Board rejected these bids as being more costly than taking interim control of the bank. On January 24, 1992, CrossLand was closed and placed into conservatorship. Appendix I provides a brief chronology of the CrossLand resolution up to the appointment of the conservator.

When it was placed into conservatorship, CrossLand was the sixth, and largest, failure faced by FDIC since FDICIA became law on December 19, 1991. It was a federal savings bank, chartered and supervised by OTS. As is the case with several hundred savings banks in the United States, CrossLand was insured by the Bank Insurance Fund (BIF), which is managed by FDIC. When it was closed, CrossLand and its numerous subsidiaries had, at book value, about \$8.7 billion in assets. CrossLand's subsidiaries included a mortgage banking firm and a savings and loan

<sup>2</sup>FDIC's net proceeds from disposing of a failed bank's assets do not include the portion of the proceeds going to other claimants. In either an insured deposit transfer or a deposit payoff, the uninsured depositors and the general creditors of the failed bank share the proceeds from asset disposition with FDIC. In states with depositor preference statutes, depositor claims are satisfied first.

<sup>3</sup>Section 141. The least-cost requirement also applies to the Resolution Trust Corporation (RTC).

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insured by the Savings Association Insurance Fund (SAIF)<sup>4</sup> and chartered in Utah, with branches in Utah, Florida, and New Jersey.

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## Results in Brief

In deciding upon a resolution for CrossLand, the FDIC Board of Directors accepted the Division of Resolutions' (DOR) recommendation to undertake interim control of CrossLand. However, the Board did not endorse the values assigned by DOR in the key assumptions made in DOR's cost evaluations. Further, the Board did not document, as required by FDICIA, the cost estimates used to arrive at its decision. Thus, we conclude that the Board's decision to take interim control of CrossLand did not comply with the documentation requirements in section 13(c) of the Federal Deposit Insurance (FDI) Act, as amended by FDICIA. Furthermore, given the absence of such documentation, we do not know what actual cost evaluations were used by the Board in arriving at its decision; thus, we cannot say on what basis they believed this action to be the least costly.

DOR identified three resolution alternatives for CrossLand—a deposit payoff, an insured deposit transfer, and a two-phase approach consisting of interim FDIC control of CrossLand followed by a final resolution in the future. In preparation for the FDIC Board's least-cost determination, DOR presented the Board with written analyses identifying its cost evaluations for each of the resolution alternatives and the assumptions underlying the evaluations. Based on the evaluations and assumptions, DOR concluded that the interim control alternative would be the least costly resolution method. DOR's cost evaluation for the interim FDIC control option relied heavily on several key assumptions that were based on staff's judgment, and the values assigned to variables in those assumptions were on the optimistic end of a spectrum of possible values discussed by the Board. The assumptions were not supported with empirical evidence, nor do FDIC's records contain any such supporting evidence. There are a sufficient number of unanswered questions about the validity of the assumptions to raise serious doubts about the savings to be achieved through interim FDIC control of CrossLand.

In view of these considerations, we have serious concerns about the quality of the decisionmaking process used by FDIC in resolving CrossLand. FDICIA requires FDIC to determine which among all resolution alternatives is the least costly. Without an improved and more rigorous decisionmaking process, it will be difficult for FDIC to meet this requirement.

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<sup>4</sup>The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 abolished the Federal Savings and Loan Insurance Corporation—the previous federal deposit insurer for savings and loans—and replaced it with SAIF, which is managed by FDIC.



## Objective, Scope, and Methodology

Our objective was to respond in one report to separate Senate and House Banking Committee requests by (1) reviewing and assessing the cost evaluations made by the FDIC Board in selecting the least costly approach to resolving CrossLand and (2) assessing the documentation of the cost evaluations. To do this, we reviewed transcripts of all FDIC Board meetings from July 9, 1991, to January 21, 1992, identified by FDIC as including discussion of CrossLand. We also reviewed FDIC staff memoranda to the Board regarding CrossLand as well as the files kept on CrossLand by DOR and the Legal Division. Finally, we reviewed a memorandum to the file dated February 3, 1992, from the FDIC's Director, Division of Resolutions (Director of Resolutions) that summarized the cost evaluations made for CrossLand.

To understand both the cost evaluations and CrossLand's history, we spoke with FDIC officials from DOR, the Division of Liquidation, and the Legal Division in Washington, D.C., as well as with Division of Supervision officials in New York City. We also interviewed the OTS Director of Resolutions to determine OTS' role in the CrossLand resolution. To understand CrossLand's condition at the time of FDIC's actions and to determine how it is currently being managed, we spoke with Arthur Andersen officials regarding their recent audit of CrossLand and with CrossLand's new Chief Executive Officer. Finally, we spoke with both unsuccessful bidders for CrossLand about their bids.

We did our work from February 1992 through May 1992 in accordance with generally accepted government auditing standards.

## FDICIA Requires Threshold Level of Documentation for Each Resolution Decision

Section 13(c)(4) of the FDI Act, as amended by FDICIA, requires FDIC to evaluate "all possible methods" for resolving a troubled depository institution and to choose the resolution method that entails "the least possible cost to the deposit insurance fund."<sup>5</sup> These statutory provisions establish the basic requirements that FDIC must meet in making its least-cost determination.<sup>6</sup> With respect to the determination itself, the statute requires FDIC to identify all resolution alternatives, to evaluate them

<sup>5</sup>Section 13(c)(4)(G) of the FDI Act provides for a systemic risk exception to the least-cost requirement if a finding is made that compliance with the least-cost requirement would have serious adverse effects on economic conditions and that a more costly alternative would mitigate such adverse effects. This exception was not invoked in the case of CrossLand.

<sup>6</sup>Section 13(c)(4) goes on to impose additional specific requirements governing the treatment of certain costs. For example, section 13(c)(4)(B)(ii) provides that if FDIC considers an alternative that would result in forgone federal tax revenues, it must treat those revenues as if they were revenues forgone by the deposit insurance fund. Section 13(c)(4)(D) deals with the calculation of liquidation costs for purposes of cost comparisons.

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by determining and comparing their costs on a present-value basis, and then to select the least costly alternative based on this evaluation.

Section 13(c)(4)(B)(i) provides that in making this least-cost determination FDIC must

“(I) evaluate alternatives on a present-value basis, using a realistic discount rate;

“(II) document that evaluation and the assumptions on which the evaluation is based, including any assumptions with regard to interest rates, asset recovery rates, asset holding costs, and payment of contingent liabilities; and

“(III) retain the documentation for not less than 5 years.”

We believe that these provisions of the statute require as a threshold matter the existence of a written record that, at a minimum, shows

- the cost estimates that the FDIC Board arrived at for each alternative it considered and
- the assumptions the FDIC Board made in arriving at those cost estimates, with enough specificity to evidence a determination on the part of the Board that the alternative it chose was, under its own analysis, the least costly to the deposit insurance fund.

The statute does not prescribe a particular format for the required documentation, nor does it necessarily require the Board to arrive at a single definitive cost estimate for each alternative considered. Under certain circumstances, a range of values may constitute an appropriate resolution cost estimate. However, in our opinion, where such ranges overlap the Board must make some determination of the expected cost within the stated range so as to be able to select the resolution alternative it judges to be least costly.

## FDIC Board's Decisionmaking in Resolving CrossLand Did Not Comply With FDICIA's Documentation Requirements

In deciding on the least costly resolution method for CrossLand, the FDIC Board did not prepare or adopt a formal document, such as a Board resolution, as evidence of the evaluation of its least-cost determination in CrossLand. Instead, the written record of the CrossLand resolution consists of staff analyses prepared for the Board's consideration, transcripts of the Board's deliberations and decision on the CrossLand resolution, and a staff memorandum prepared after the Board's resolution decision.

On January 21, 1992, the FDIC Board, by majority vote, adopted the interim control alternative recommended by DOR. Although the Board apparently accepted DOR's bottom-line conclusion that this alternative would be the least costly, it is evident from the transcripts that Board members disagreed to some unmeasurable extent with the values that DOR had assigned to the key assumptions underlying the interim control alternative. (These key assumptions are described later in this letter.) Board members debated the key assumptions and at several points discussed the appropriateness of the values assigned to them by the staff. Certain participants appear to have advocated rejecting various assumptions entirely. The important point, however, is that the record does not indicate what, if any, assumptions and cost estimates the Board actually adopted in lieu of those proposed by DOR.

Following the Board's determination, FDIC's Director of Resolutions prepared a memorandum to the file, dated February 3, 1992, with the stated purpose of documenting the assumptions used in the CrossLand cost analysis. There is no indication in the record that this memorandum was approved by the Board. In any event, the memorandum provides only a very general outline of the Board's assumptions underlying the interim control alternative. Moreover, it identifies DOR's cost estimate for the interim control alternative and for the other two alternatives. Further, it confirms that the Board did not fully accept this evaluation, stating that

"[w]hile the Board did not adopt every detail of this analysis—finding that the overall cost of both alternatives could be greater, and that the differences between the two could be smaller—it endorsed the conclusions with regard to what strategy would result in the least cost to the Bank Insurance Fund."

In summary, there was no document or compilation of documents pertaining to the CrossLand resolution that show the Board's assumptions or the cost estimate resulting from those assumptions for the interim

control alternative that it chose. This documentation was lacking for the other two alternatives as well. Because the Board did not adopt DOR's assumptions and estimates or quantify the extent of its departures from DOR's assumptions and cost estimates, the record did not show the Board's projected cost for each resolution alternative.

Since there was no record attributable to the Board documenting the Board's evaluation and assumptions, we concluded that the Board did not comply with the section 13(c)(4) documentation requirements. Furthermore, in the absence of such documentation or any other articulation by the Board of the cost estimates and assumptions underlying the various resolution options, we cannot say on what basis the Board believed interim FDIC control to be the least costly option as required by section 13(c)(4) of the FDI Act.

## Criteria for Evaluating the Adequacy of Cost Evaluations

Apart from the issue of whether the FDIC Board fulfilled FDICIA's requirements in making its resolution decision, we reviewed the staff analyses done in preparation for the Board's decisionmaking. Specifically, we assessed the adequacy of DOR's cost evaluations and its documentation of those evaluations.

Because of the unique facts and circumstances surrounding each resolution case, we believe that the amount and type of support underlying each resolution decision may differ. While we understand that variations in documentation may exist as a result, we believe that certain general documentation criteria would aid FDIC in ensuring the adequacy of support for the Board's evaluation and its assumptions. At the time of CrossLand's resolution, FDIC had no written policy specifying the support necessary to document its least cost resolution decisions, nor have such policies yet been developed. Accordingly, we developed the documentation criteria set forth next and have discussed these criteria with FDIC's Director of Resolutions and with senior staff in their Legal Division who raised no objections.<sup>7</sup> These criteria are as follows:

- Documentation should be clear, consistent, concise, and complete so that an outside observer can identify and understand the estimated cost of each option, including the assumptions and discount rates used.
- Data sources for the cost evaluations should be clearly identified so that cost figures can be traced to their source.

<sup>7</sup>We intend to rely on such criteria when reviewing resolution decisions as part of our annual compliance audit—that is required by FDICIA—of FDIC and RTC failure resolutions.



- Assumptions integral to the cost evaluations should be documented and supported. In particular, each assumption should be
  - clearly identified.
  - supported by empirical data or, in the absence of such data, by judgment based on relevant experience. This support should be explicitly described in the documentation and, where appropriate, the source(s) used in making the assumption should be identified.
- If there is uncertainty about the validity of an assumption that materially affects the cost evaluation results, some effort to gauge that uncertainty should be made and documented by showing a range of possible outcomes.

The following sections describe DOR's cost evaluations and supporting analyses and evaluate them under the criteria previously set out. Although we focus on DOR's cost evaluations and supporting analyses, it is the FDIC Board, not DOR, that is ultimately responsible for choosing the least costly resolution method in accordance with section 13(c)(4) of the FDI Act.

## Cost Evaluations Prepared by DOR Showed Interim FDIC Control Less Costly Than Insured Deposit Transfer

Table 1 shows DOR's estimates of the expected present-value<sup>8</sup> cost of each resolution option presented to the FDIC Board.

**Table 1: DOR's Cost Evaluation  
Results**

Dollars in millions	
<b>Resolution option</b>	<b>Estimated present-value loss to BIF</b>
Deposit payoff	\$1,297
Insured deposit transfer	1,280
Interim FDIC control	763

Source: February 3, 1992, memorandum to the file signed by FDIC's Director of Resolutions.

<sup>8</sup>FDICIA requires FDIC to estimate the expected cost of each resolution option on a present-value basis. Present-value analysis discounts cash received in the future to the value of cash received today. That is, it recognizes and adjusts for the fact that \$100 received 5 years from now, because of the time value of money and inflation, is worth less than \$100 received today.

The least costly of the two private sector bids received by FDIC was a proposal to assume CrossLand's insured deposits for a premium of approximately \$17 million, leaving a net cost to FDIC of \$1.28 billion.<sup>9</sup> Under this resolution option, FDIC, as receiver, would be responsible for disposing of all of CrossLand's assets, including its subsidiaries.<sup>10</sup> If FDIC had undertaken a deposit payoff of the insured depositors, its expected cost would have been greater by \$17 million, the amount of the premium, yielding a net cost of \$1.297 billion. However, DOR estimated that if FDIC delayed the final resolution by putting CrossLand into conservatorship, and then prepared CrossLand to be remarketed in a more receptive future environment, the expected present-value cost of the resolution would be \$763 million. DOR's estimated cost difference between the deposit payoff and interim FDIC control was thus \$534 million.

## Assumptions Justifying Interim FDIC Control Lacked Documented Empirical Support

This section describes the assumptions DOR used in arriving at its cost evaluation for interim FDIC control. These assumptions explain the difference between the expected cost of interim FDIC control and that of a deposit payoff.

Before describing DOR's assumptions, we should note that DOR's mid-January 1992 cost evaluations were based on obsolete data. Specifically, all the cost evaluation results are based in large part on the total asset purchase and assumption (TAPA)<sup>11</sup> estimates of the expected recovery on assets done by FDIC's Division of Liquidation. The TAPA review for CrossLand was completed in July 1991 and was based on CrossLand's March 31, 1991, financial statement. Furthermore, the TAPA review did not cover CrossLand's subsidiaries.

<sup>9</sup>As noted in the background section, a bid for insured deposits is made in terms of the premium offered. In CrossLand's case, the premium of about \$17 million offered in the least costly bid means that the bidder was willing to assume CrossLand's insured deposits and receive cash from FDIC in an amount equal to \$17 million less than the total amount of the insured deposits. Such a bid is often expressed as a percentage of the deposits acquired. In CrossLand's case, the premium offered was about 0.3 percent.

<sup>10</sup>Neither bidder bid on the deposits of the SAIF-insured savings and loan owned by CrossLand. If the insured deposit transfer had been done, the savings and loan subsidiary still would have been owned by FDIC. In marketing CrossLand, FDIC also marketed this subsidiary, but there was no expressed interest in the subsidiary as a whole.

<sup>11</sup>A TAPA review is an estimate of FDIC's expected recoveries on assets if FDIC disposes of the assets itself. Traditionally, FDIC used the TAPA estimate to identify the price at which it was indifferent to selling all of a failed bank's assets to an acquirer or disposing of the assets itself. TAPA is also used as the basis for the cost of a deposit payoff, since, in a deposit payoff, FDIC must dispose of all of the failed bank's assets.

Although we did not review the reasonableness of the TAPA methodology and its implementation, our experience with the Resolution Trust Corporation (RTC) has shown that asset valuations become obsolete quickly, especially if assets are changing in value. Although DOR made certain adjustments to update the TAPA estimate for interest rate movements and additional loan loss provisions made by CrossLand, we believe the length of time between the initial TAPA and the cost evaluations was sufficient to raise the issue of the validity of the data used. Due to this time lag, the estimated asset recoveries under each resolution option may be misstated. Further, invalid TAPA estimates could result in an over- or underreserving for losses by FDIC. At a minimum, the files should have made clear why DOR believed that it was not necessary to update the TAPA review and should have clearly identified and supported the adjustments made to the original TAPA.

The cost evaluation is, in essence, a series of mathematical calculations that yield an expected present-value resolution cost for each resolution option considered. The results depend on the input variables used and the value assigned to each. To select input variables for costing the interim FDIC control option, DOR made certain key assumptions. These assumptions are discussed next.

### Conservatorship Believed to Save FDIC 10 Percent on Certain Asset Losses

In doing the cost evaluation for any resolution, FDIC must make estimates regarding its expected recovery on assets for each resolution option. In the CrossLand case, DOR assumed that FDIC would recover more on certain "difficult assets" by managing and disposing of them in an open institution (the conservatorship) than by using its normal methods of asset management and disposition.<sup>12</sup> DOR defined CrossLand's difficult assets as commercial loans, including real estate loans and other assets that were not readily marketable (such as real estate owned), and estimated that CrossLand had about \$4.4 billion in such assets. DOR assumed that, if these assets were managed under a conservatorship, losses on them would be 10 percent less than if the insured deposit transfer bid was accepted and FDIC's normal asset disposition procedures were used. Therefore, 10

<sup>12</sup>If a deposit payoff or an insured deposit transfer were done, CrossLand's assets would have gone to FDIC's Division of Liquidation, which in turn planned to hire a private sector firm to manage and dispose of the assets.

percent of \$4.4 billion yields an expected cost savings to FDIC of \$440 million.<sup>13</sup>

This 10-percent assumption explains the single biggest difference between the expected cost of a deposit payoff or insured deposit transfer and that of interim FDIC control. The \$534 million difference between the estimated cost of a deposit payoff and interim FDIC control shrinks to \$94 million in the absence of the 10-percent assumption.

The assumption regarding asset value recoveries was based primarily on the judgment of DOR. FDIC's Division of Liquidation disagreed with this assumption, believing that any cost difference in asset recovery to be small if it existed at all. There was no evidence that the FDIC Board reconciled this disagreement.

We understand that certain assumptions may need to be based on the judgment and experience of FDIC staff because empirical data are not available. However, we also believe the record should lay out the support for such judgments. Both FDIC and OTS resolutions staff firmly believe that asset recoveries are greater when achieved by an operating depository institution than under management by government officials themselves or under contract to the private sector. Yet neither organization can substantiate these claims with empirical evidence, and FDIC records do not contain any such evidence. Also, there was no evidence that FDIC made similar 10-percent assumptions regarding asset recoveries in other resolutions.

## CrossLand's Franchise Value Estimated to Be Greater in the Future

The other key assumptions made in DOR's cost evaluation regarding interim FDIC control had to do with CrossLand's future franchise value—that is, the value of the firm as an ongoing entity. These assumptions concerned (1) CrossLand's projected income while in conservatorship, (2) the future sales price FDIC will realize when a final resolution is undertaken, and (3) the relationship between protecting

<sup>13</sup>In tracing the development of this assumption, we found that the 10-percent savings figure was used consistently. However, there was considerable disagreement over time on what assets DOR staff thought FDIC could achieve such savings. During a December Board meeting, the Director of Resolutions stated that the 10-percent savings could be realized on \$2.5 billion of nonresidential performing loans. In this same meeting, he questioned whether any savings could be obtained on problem assets such as other real estate owned or nonperforming loans. In the cost tests prepared in January, DOR staff greatly expanded the set of assets on which such savings could be achieved. Here, the staff showed a broader range of assets (about \$4.4 billion), including nonperforming loans and real estate owned, as subject to a 10-percent improvement on recoveries if left in CrossLand. There was no explanation given in the files as to why these previously excluded classes of assets were included in the later cost evaluations.

uninsured depositors and preserving interest rates on deposit contracts and CrossLand's franchise value. By improving CrossLand's franchise value in the conservatorship, DOR anticipates realizing greater sales proceeds when the CrossLand resolution is completed.

The key values chosen by DOR to use in the assumptions regarding future sales proceeds were the projected income figures and the assumed sales multiple of 1.5 times the book value of equity projected to be in CrossLand at the end of 2 years.<sup>14</sup> In establishing the conservatorship, FDIC injected \$1.2 billion, enough cash to bring CrossLand's capital level to about the regulatory minimum.<sup>15</sup> DOR assumed that CrossLand would earn \$69 million after taxes in each of the next 2 years.<sup>16</sup> DOR projected that, at the end of the 2 years, CrossLand would repay \$203 million of FDIC's cash infusion. The \$203 million figure was chosen so as to leave CrossLand at about the regulatory minimum.<sup>17</sup> DOR also projected that after 2 years CrossLand can be sold for 1.5 times its remaining equity value.<sup>18</sup>

#### Projected Income Not Well Supported

In projecting after-tax income for the conservatorship, DOR assumed that CrossLand's net income would improve because it has no more significant loan losses to record after the portfolio is marked-to-market—which was to be done when the conservatorship was created—and because high cost loans from Federal Home Loan Banks were to be replaced by lower cost funds.

The income projection also assumed an unchanging interest rate environment and no significant additional deterioration in the value of the loan portfolio.<sup>19</sup> It made no adjustment for the fact that CrossLand was expected to shrink by about \$1 billion per year. DOR acknowledged that a shrinking bank has fewer earning assets, but DOR staff advised us that the effect of this shrinkage on income would be offset by including nonearning

<sup>14</sup>If only the deposit base is sold in 2 years, this would equate to a 2.5 percent deposit premium.

<sup>15</sup>Of this \$1.2 billion, \$832 million extinguished CrossLand's negative net worth, and the remaining \$368 million was considered equity.

<sup>16</sup>Projected income for the 2 years, after taxes and after deducting an outstanding New York state tax liability, was \$85 million.

<sup>17</sup>The DOR staff analysis showed that the future sales multiple would be lower if the \$203 million repayment was not made. In that case, although the multiple would go down, the amount of equity sold would be greater, so the net proceeds to FDIC would remain about the same.

<sup>18</sup>Equity in this context is the portion of FDIC's cash infusion counted as positive capital, net of the amount repaid, plus its net after-tax income over the period of the conservatorship.

<sup>19</sup>The income projections foresaw only minimal additional loan losses the next 2 years because the bad loans were to be charged off at the creation of the conservatorship.



assets in the shrinkage and by lowered operating expenses. That is, some of the shrinkage would be due to removing nonearning assets from the balance sheet and thus would have no effect on income. And, because the bank would be shrinking, they anticipated that CrossLand's overhead expenses would decline.

We found no substantial support for DOR's income projections. The relevant projections showed certain adjustments to CrossLand's income for the first 11 months of 1991 but provided no additional basis for determining future net income. In particular, it is not apparent how and when DOR assumed CrossLand would downsize over the period before its final resolution, how the downsizing would affect income, or how operation of the conservatorship would affect noninterest expenses.

#### Projected Sales Multiple Not Adequately Justified

We asked DOR to explain the basis for the 1.5 sales multiple. DOR staff told us that such a multiple is typical of recent acquisitions in the private sector of adequately capitalized institutions and that recent acquisitions have had multiples as high as 2.5. We were referred to national trade papers and a schedule of recent bank and thrift merger deals for supporting evidence.

We are concerned about the support for the future sales multiple. In particular, we are concerned that even if national figures reflect multiples as high as 2.5, such figures may not be representative of reasonable multiples for the purchase from FDIC of savings banks in the New York market. We did not independently research such multiples, but we believe that reasonable support for this assumption should be based on, and supported by, such relevant evidence. We also note that such figures change over time, reflecting market conditions. As we describe in more detail next, it would have been reasonable for DOR to analyze the sensitivity of assumptions—and perhaps provide a range of values—when there is such uncertainty about future outcomes.

To provide a sense of the magnitude of FDIC's estimated future sales proceeds, we recalculated the future sales proceeds, changing only the assumption about the book value multiple. Assuming a multiple of 1, which implies the bank would sell at the book value of its equity, the projected cost of the interim FDIC control option would increase by \$94 million.

Even accepting DOR's basis for the 1.5 sales multiple, it is reasonable to question why CrossLand could not have been sold in January 1992 for 1.5 times the book value of the equity FDIC infused into CrossLand. We asked

DOR staff why they believe that the market value realized in the future for CrossLand would be any different than what it is today. In response, they said that enhanced value in the future will come from stabilizing CrossLand; shrinking it to a core, consumer-oriented savings bank; and improved liquidity for commercial real estate assets. They also identified for us the following other obstacles that exist today that prevent FDIC from realizing greater value now for CrossLand: (1) potential acquirers are adjusting to higher capital requirements; (2) falling interest rates make core deposits relatively less attractive; and (3) to a lesser extent, current economic conditions appear to offer limited asset investment opportunities. Although these explanations may be plausible, we found no supporting evidence showing the extent to which DOR staff considered these obstacles in making their assumption about future sales proceeds.

#### Protecting Uninsured Depositors Believed to Preserve Franchise Value

The third assumption DOR made that affected the estimated future franchise value of CrossLand involved treatment of uninsured depositors and certain deposit contracts. DOR assumed that it was less costly to protect uninsured depositors than to force them to share in CrossLand's losses.<sup>20</sup> Similarly, DOR assumed that breaking CrossLand's deposit contracts in order to lower CrossLand's interest expenses would reduce the franchise value by more than the projected savings on interest expenses.

The basis for these assumptions rested largely on the assumption that depositor reaction to both losses imposed on uninsured depositors and broken rates on deposit accounts would result in large outflows of core deposits. Such outflows, reasoned DOR, would reduce CrossLand's franchise value and thus reduce the expected sales proceeds to be earned when CrossLand is sold to the private sector. The reduction in future sales proceeds received by FDIC was thought to be greater than the cost of protecting the uninsured depositors and preserving deposit contracts.

We found no documented support for these assumptions about depositor reactions. However, DOR did provide a matrix of possible outcomes for the Board to consider. That is, for these assumptions DOR's analysis included a range of possible changes to CrossLand's franchise value and thus the future sales proceeds. It then identified the outcome it felt was most probable.

<sup>20</sup>When the conservatorship was created, CrossLand had approximately \$132 million in uninsured deposits and \$5.5 billion in total deposits.

## Sensitivity Analysis Needed to Show Uncertainty Imbedded in Cost Evaluation

The cost evaluation of certain resolution options may be subject to greater uncertainty than evaluations of other options for the same failed bank. For example, in doing a cost evaluation, FDIC may have to rely on projections of future economic conditions. Such projections, however, are inherently uncertain. When CrossLand was put into conservatorship, FDIC had no written policy specifying how uncertainty should be incorporated into cost evaluations, nor have such policies yet been developed. To prevent cost evaluations from being biased by overly optimistic or pessimistic assumptions, we believe that FDIC should, under certain circumstances, consider a range of possible cost estimates to account for such uncertainty.

An important aspect of the interim FDIC control of CrossLand is the extent to which the actual resolution cost may vary from the estimated cost. The cost estimate for the interim FDIC control option is more uncertain than those estimates for a deposit payoff or insured deposit transfer. This uncertainty is because the ultimate cost to FDIC of interim FDIC control could be higher or lower, depending on actual market conditions and other factors. The reason the cost evaluation for a deposit payoff or insured deposit transfer involves less uncertainty is that all of CrossLand's liabilities and roughly half of its assets that were readily marketable—primarily residential mortgage loans—would have been disposed of within 6 months. As a result, there would have been little time for economic conditions or other factors to change enough that the realized proceeds differed much from the expected proceeds. On the other hand, DOR staff did not appear to contemplate this rapid a sale of readily marketable assets in their projections of CrossLand's downsizing.

As described earlier, DOR's assumptions about asset recoveries and franchise value were based on specific judgments about future conditions. In doing the cost evaluation for the interim FDIC control option, DOR assigned specific values for the key factors in these assumptions (e.g., that 10 percent would be the savings on asset recoveries and 1.5 would be the sales multiple). The actual outcome—that is, the actual savings on sales recoveries and the actual sales multiple—is uncertain because the outcome depends on external factors such as future economic conditions. A logical question to ask, therefore, is what would happen if less optimistic values were used in the assumptions? For example, changing the 10-percent figure to 0 percent and the sales multiple to 1 would make the estimated cost of interim FDIC control about the same as that of a deposit payoff.

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There was considerable disagreement among individual Board members and FDIC staff on the proper values to apply in the key assumptions. Further, the values assigned by DOR were at the optimistic end of the spectrum of possible values discussed during the Board meetings. There was no analysis of the impact on the cost evaluation results of using less optimistic values in the assumptions, nor was there analysis of the likelihood of achieving the optimistic outcomes.

We believe that a reasonable and complete cost analysis should sometimes include measurement of the sensitivity of a cost evaluation result to the assumptions used. While we do not feel that such sensitivity analysis is required for every option in a resolution, we believe that such analysis is appropriate when projected costs are highly variable and when this variability may have a significant impact on the loss to a deposit insurance fund. CrossLand is such a case. Because the outcome of DOR's cost evaluation of interim FDIC control depended so heavily on the values assigned in the assumptions, we believe that this evaluation should have included some consideration of this uncertainty.

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## Conclusions

The documentation presented to us by FDIC regarding the CrossLand resolution alternatives reflected the cost evaluations made by DOR. This documentation did not contain the FDIC Board's determination of the expected cost of each resolution alternative considered, nor did it contain the assumptions underlying such cost estimates.

The actual cost of each resolution option FDIC considered will depend on future events. However, the estimated cost of the interim control option relied heavily on the use of assumptions about the future and is thus subject to greater uncertainty than the cost evaluations for the other options considered. The values assigned by DOR in the assumptions made regarding the cost of interim FDIC control, although optimistic, may be plausible. However, different values with a less optimistic view of the future could lead to different decisions about which option was the least costly. As noted earlier, the assumptions were not supported with empirical evidence, nor do FDIC's records contain any such supporting evidence. There was a sufficient number of unanswered questions about the validity of the assumptions made to raise serious doubts about the savings to be achieved through interim FDIC control of CrossLand.

In view of all these considerations we have serious concerns about the quality of the decisionmaking process used by FDIC in resolving CrossLand.

FDICIA requires FDIC to determine which among all resolution alternatives is the least costly. Without an improved and more rigorous decisionmaking process, it will be difficult for FDIC to meet this requirement.

In addition, DOR's assumption that recoveries on certain assets would be 10-percent greater by keeping those assets out of FDIC raises questions about FDIC's ability and capacity—directly or under contract—to efficiently manage and dispose of such assets. We believe this is an appropriate area for FDIC to review in order to determine whether and under what circumstances such a cost difference in expected asset recovery exists and how any such added losses can be minimized.

## Recommendations

The Chairman of FDIC should

- ensure prompt development and implementation of policies governing the complete and consistent documentation of the agency's resolution actions. As required by section 13(c)(4) of the FDI Act, the FDIC Board must document the alternatives considered and the evaluation of each alternative, including the cost that the Board attributes to each alternative and the assumptions on which its cost evaluations are based. The record should also include appropriate documentation to support the assumptions underlying the Board's cost estimates and evaluations.
- assess and report on FDIC's policies, practices, and historical experiences, as well as those of open banks, in disposing of troubled assets that are not readily marketable. The study should determine whether, and under what circumstances, FDIC's operations create a cost difference in expected recoveries on such assets. If recoveries are found to be less under FDIC control or contract, FDIC should develop methods to minimize or avoid such added losses.
- develop policies for determining when and how uncertainty should be incorporated into the cost evaluations.

## Agency Comments

FDIC disagreed with our conclusion that its resolution actions with regard to CrossLand did not comply with the documentation requirements of the least-cost test provisions of FDICIA. FDIC said that its written analyses as well as the official transcripts of the FDIC Board of Directors' deliberations constitute its documentation of the resolution and that this documentation fully complies with the least cost provisions of FDICIA. (See app. II.) We do not agree that the FDIC complied with the documentation requirements contained in FDICIA for the reasons we described. (See pp. 4-7.)



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FDIC made the point that in "any resolution decision, the Board must exercise prudent business judgement to determine the least cost alternative . . . ." We recognize that certain assumptions may need to be based on judgment. (See p. 11.) However, we also note that the record should include the support for such judgments.

FDIC said it appreciates our recommendations, but it did not address them specifically. FDIC said that it has been developing and implementing policies and procedures to enhance its compliance with the documentation of the resolution decisionmaking process, and it looks forward to further constructive dialogue on this topic. We welcome such dialogue. FDIC also said it is gathering comparable data on asset recoveries and asset disposition methods that will be useful to the Board in the resolution decisionmaking process.

FDIC staff also provided informal comments, which have been included as appropriate.

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We are sending copies of this report to the chairman of FDIC, the president and chief executive officer of RTC, and other interested committees and agencies. We will also make copies available to others upon request.

The major contributors to this report are listed in appendix III. If you have any questions about this report, please call Craig Simmons, Director, Financial Institutions and Markets Issues, on (202) 275-8678.



Richard L. Fogel  
Assistant Comptroller General



# Resolution Process for CrossLand Took 9 Months

OTS notified FDIC on March 29, 1991, that CrossLand would likely fail in the next 60 to 90 days. FDIC began the resolution process in April 1991. This process involved developing an information package to distribute to potential bidders and preparing the TAPA estimate. On July 5, 1991, OTS regional staff formally recommended to the OTS Assistant Director for Supervision Operations that OTS appoint FDIC as receiver for CrossLand.

On July 9, 1991, the FDIC Board first discussed the resolution of CrossLand. At that time, the staff recommended that the Board put CrossLand into conservatorship.<sup>21</sup> The purpose of the conservatorship would be to give FDIC time to get control of CrossLand and market it to the private sector. The Board, however, chose to resolve CrossLand while it remained open. Ten bidders attended a bidders conference held by FDIC in August; about 5 months later, FDIC had received two formal bids. Both bids were limited to purchases of some portion of CrossLand's deposits, and neither bidder wanted to purchase any of CrossLand's assets. Faced with the options of these two bids, a deposit payoff, or interim control of CrossLand utilizing a conservatorship, the FDIC Board voted on January 21, 1992, to accept the conservatorship as the least costly alternative.

OTS closed CrossLand Savings, FSB, on January 24, 1992, and named FDIC receiver.<sup>22</sup> As receiver for CrossLand, FDIC immediately transferred nearly all of its assets and all of its deposits to a newly chartered federal mutual savings bank for which OTS appointed FDIC as conservator.<sup>23</sup> FDIC appointed a former savings and loan executive to run CrossLand as its chief executive officer. This individual was instructed to manage the bank conservatively, downsize it, and prepare it for sale within 2 years.

<sup>21</sup>FDIC staff recommended a conservatorship as the functional equivalent of a bridge bank because CrossLand, in its federal savings bank form, could not be "bridged" into a national bank. FDIC received authorization in section 503 of the Competitive Equality Banking Act of 1987 to establish bridge banks to hold failing banks. A bridge bank, which must be a national bank, may operate for up to 2 years (with the option for three 1-year extensions) and need not meet capital requirements.

<sup>22</sup>A receivership is the functional equivalent of bankruptcy for a failed bank. FDIC, as receiver, is responsible for the disposition of the assets of a failed bank and repayment of its creditors to the best extent possible. FDIC is the major claimant.

<sup>23</sup>All but a few loans and certain contingent liabilities passed from the receivership to the conservatorship. The formal name of the new institution is CrossLand Federal Savings Bank.

# Comments From the Federal Deposit Insurance Corporation



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

June 17, 1992

Mr. Richard L. Fogel  
Assistant Comptroller General  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Fogel:

Thank you for the opportunity to comment on the draft of the General Accounting Office's report (the "Report") on the resolution of CrossLand Savings, FSB ("CrossLand Savings").

Since the enactment of The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), our agency has been developing and implementing policies and procedures to enhance our compliance with all aspects of FDICIA, including the least-cost and related provisions of this law. We therefore appreciate the recommendations contained in the Report with respect to the FDIC's implementation of policies regarding the documentation of the resolution decision-making process, and look forward to further constructive dialogue on this topic. However, we disagree with the Report's conclusions. Although specific policies and procedures may not have been fully implemented at the time of the CrossLand Savings resolution, the FDIC believes that the process which resulted in the decision to pursue interim ownership of CrossLand Savings represented full compliance with FDICIA.

The written analyses as well as the official transcripts of the FDIC Board of Directors' (the "Board") deliberations constitute the Agency's documentation of the resolution of CrossLand Savings. As with any resolution decision, the Board must exercise prudent business judgement to determine the least cost alternative when considering staff's analyses of all relevant resolution possibilities. In the resolution of CrossLand Savings, the Board determined that more could be recovered on approximately \$4.4 billion of difficult assets by assuming interim ownership of CrossLand Savings than if a liquidation approach had been pursued. Accordingly, the Board determined that interim ownership would be least costly to the Bank Insurance Fund (the "BIF").

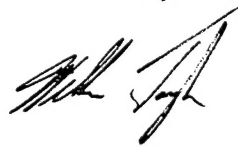
**Appendix II**  
**Comments From the Federal Deposit**  
**Insurance Corporation**

Mr. Richard L. Fogel  
June 17, 1992  
Page 2

The FDIC staff assembles and analyzes all relevant information available on each resolution for consideration by the Board. Because of the nature of the resolution process and the lack of relevant empirical data, staff must make recommendations and the Board must make decisions based on less than perfect information. The FDIC is gathering comparative data on asset recoveries and asset disposition methods which will be useful to the Board in the decision making process in the future. However, any such data must be used in conjunction with the Board's exercise of common sense and business judgement. The Board believes that such a process is consistent with the intent of FDICIA and with our fiduciary responsibility to the BIF.

If you would like to discuss our comments on the Report, please contact Harrison Young, Director, Division of Resolutions at (202) 898-6834.

Sincerely,

A handwritten signature in dark ink, appearing to read 'H. Young', is written over a horizontal line.



# Major Contributors to This Report

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